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2 **REBUTTAL TESTIMONY**

3 **OF**

4 **KEVIN MARSH**

5 **ON BEHALF OF**

6 **SOUTH CAROLINA ELECTRIC & GAS COMPANY**

7 **DOCKET NO. 2002-223-E**

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9  
10 **I. INTRODUCTION**

11  
12 **Q: PLEASE STATE YOUR NAME FOR THE RECORD.**

13 A. Kevin Marsh.

14 **Q. HAVE YOU PREVIOUSLY TESTIFIED IN THIS MATTER?**

15 A. Yes, I have.

16 **Q. THE NAVY'S WITNESS, MR. DONALD COATES, HAS TESTIFIED**  
17 **CONCERNING THE COMPANY'S PENSION ADJUSTMENT. WHAT**  
18 **COMMENTS DO YOU HAVE ON THIS TESTIMONY?**

19 A. Mr. Donald Coates asserts that the Company's pension adjustment is not  
20 appropriate because it is based on "recent data" that he believes is not more  
21 representative of a "normal year" than the actual test year data. His  
22 comments indicate a misunderstanding of how pension liabilities and related

1 costs are recognized in the Company's operating results. In addition, there  
2 is clear Commission precedent concerning this precise issue.

3 **Q: PLEASE DISCUSS THE EXISTING COMMISSION PRECEDENT.**

4 A. The Company's pro forma adjustment of pension expenses was based  
5 directly on Commission Order No. 93-465. In that order, the Commission  
6 ruled in favor of a position advanced by the Consumer Advocate and found  
7 that "the test year pension expense should be based on the latest actuarial  
8 study. . . . [T]his amount is appropriate and is also consistent with the  
9 treatment of pension expense by other regulatory commissions." Order No.  
10 93-465 at p. 14.

11 **Q: WHY IS THE PROPOSED PENSION EXPENSE APPROPRIATE?**

12 A. The Company's pension obligation is based on a current valuation of both  
13 pension liability and plan asset market values. Statement of Financial  
14 Accounting Standards Number 87, Employers' Accounting for Pensions, is  
15 the applicable accounting standard that sets forth the specific rules for  
16 calculating a company's annual pension obligation. Based on this  
17 accounting standard, annual pension expense, or income, is determined  
18 based on an actuarial study, conducted by certified actuaries, which  
19 evaluates the Company's future pension liability compared to the current  
20 market value of pension fund assets and the likely levels of earnings on  
21 these assets. These actuarial studies are updated annually as of December

1 31<sup>st</sup> and from time to time within a year if market conditions require. The  
2 December 31<sup>st</sup> study serves as the basis of accounting for pensions in the  
3 following year.

4 The actuarial study on which the proposed pension obligation in the  
5 pro forma adjustment was conducted by the firm of Towers Perrin. It  
6 reflects a pension plan asset value of \$760 million, which is an amount that  
7 is at the midpoint between the plan asset levels at December 31, 2001 and  
8 the asset level at the time the pro forma adjustment was calculated. The  
9 actual value of pension plan assets at the time the study was conducted was  
10 \$688 million. In effect, the Company has based its adjustment on the  
11 assumption that the market will recover and restore to plan asset values 50%  
12 of the value lost since the beginning of the year. Since the calculation of the  
13 pro forma adjustment to pension income, market values in the company's  
14 pension plan have fallen another \$60 million to as low as approximately  
15 \$628 million as of October 4, 2002. This would have resulted in a larger  
16 reduction to pension income in the Company's pro-forma adjustment.  
17 These facts demonstrate the reasonableness of the Company's proposed  
18 adjustment.

19 It is standard business and regulatory practice to base employee  
20 expenses and related benefits on the most current actuarial or other  
21 information concerning those expenses. The Company's proposed

1 adjustment does this, while Mr. Donald Coates proposal does not.

2 **Q: THE SOUTH CAROLINA ENERGY USERS COMMITTEE'S**  
3 **WITNESS MR. PHILLIPS HAS TESTIFIED REGARDING THE**  
4 **COMPANY'S NEW JASPER COUNTY GENERATING FACILITY.**  
5 **WHAT COMMENTS DO YOU HAVE IN RESPONSE TO HIS**  
6 **TESTIMONY?**

7 A. Mr. Phillips raises questions about the appropriateness of including the cost  
8 of construction work in progress (CWIP) for the Company's new Jasper  
9 County generating facility through December 31, 2002 in rate base in this  
10 proceeding. Mr. Phillips believes that all of the Jasper County project CWIP  
11 should be excluded from rate base because it is not used and useful in  
12 providing electric service to South Carolina ratepayers. This position is  
13 incorrect.

14 The Commission addressed the issue of including CWIP in rate base  
15 in its Order 93-465 issued June 7, 1993 in Docket No. 92-619-E. In this  
16 Order, the Commission considered the appropriateness of inclusion of  
17 CWIP associated with new generating plant construction in rate base  
18 without offset for the allowance for funds used during construction  
19 ("AFUDC"). The Order specifically addressed construction expenditures  
20 for the Company's new Cope generation facility that was under construction  
21 at the time and was not expected to be placed into service until January of

1 1996. The Cope plant was constructed under a contract with Duke/Fluor  
2 Daniel that required the Company to make progress payments on specified  
3 dates during the construction schedule. This arrangement allowed the  
4 Company to fix the cost of a significant portion of the facility resulting in a  
5 very favorable and competitive cost for the Cope plant. Following its  
6 review of this matter, the Commission in Order 93-465 concluded that the  
7 Company should be permitted to include CWIP in rate base for the Cope  
8 Plant without offset for the allowance for funds used during construction.  
9 The Commission further found that the expenditures on the Cope Plant were  
10 known and measurable, and not speculative, since they were committed and  
11 to be paid pursuant to the construction contract with Duke/Fluor Daniel.

12 The Jasper County generation facility is being constructed under a  
13 contract with Duke/Fluor Daniel that is structured in a fashion very similar  
14 to the contract for the Cope project. The Jasper County project contract  
15 provides for specific progress payments upon the completion of certain  
16 milestones in the construction of the project. Payments are tied to  
17 construction milestones that require work to be completed, and materials to  
18 be fabricated and supplied, before payment is made. In all cases, the  
19 Company inspects and certifies that the contemplated value has been  
20 received before milestone payments are made.

21 Work completed under the contract and payments made can be

1 easily audited and verified. The costs associated with the Jasper County  
2 project through December 31, 2002 are known and measurable and we  
3 expect them to be verified by the Commission Staff prior to inclusion in  
4 rates in this proceeding, just as was the case in the Cope proceedings.  
5 Therefore, the Company reaffirms its belief that the inclusion of CWIP  
6 associated with the Jasper County project in rate base with no offset for  
7 allowance for funds used during construction is both appropriate and  
8 consistent with prior Commission decisions on this CWIP issue.

9

10 **Q: DID MR. PHILLIPS MAKE ANY OTHER COMMENTS REGARDING**  
11 **THE JASPER COUNTY PROJECT YOU WISH TO ADDRESS?**

12 A. Yes. Mr. Phillips states that the Company's Jasper County project is not  
13 used and useful. He further states the Company's request to include Jasper  
14 County project expenditures in rate base is unusual because the construction  
15 time for the plant is relatively short, interest rates are low, and the economy  
16 is in an economic downturn.

17 The Jasper County project is necessary to maintain generation reserves  
18 at a level that will provide for efficient operations and reliable service to  
19 our customers. Those facts alone should qualify the Jasper County project  
20 as used and useful. (I would also note that South Carolina regulation has  
21 long recognized that property held for future use is properly included in

1 utility rate base.) While the construction period for the Jasper project may  
2 not be as long as for other types of generation facilities, there are  
3 significant benefits to be gained from the inclusion of these plant  
4 construction expenditures in rate base without an offset for AFUDC.

5 By including the Jasper County project in rate base, the Commission  
6 eliminates the need to capitalize additional financing costs associated with  
7 the project while it is under construction through an allowance for funds  
8 used during construction (AFUDC). Customers begin paying for the costs  
9 associated with new generating plant facilities while construction is  
10 underway. As a result, the final cost of the project will be greatly reduced,  
11 resulting in lower costs to customers when the project is completed. This  
12 fact also was acknowledged by the Commission in Order No. 93-465. That  
13 Order, at pages 39-41, contains a detailed description of the many benefits  
14 to customers and to the electric system. All of those benefits apply fully the  
15 CWIP treatment the Company is proposing for the Jasper Project.

16

17 **Q: HOW DO INTEREST RATES IMPACT THE COST OF THE JASPER**  
18 **COUNTY PROJECT?**

19 A. Until cash from operations is available, the Company must either borrow  
20 money or sell stock to underwrite its generation construction of plants such  
21 as the Jasper facility. The interest paid to creditors for the use of these

1        borrowed funds along with the cost of equity financing is either recorded as  
2        a current expense or capitalized through AFUDC and added to the cost of  
3        construction projects. Naturally, when interest rates are down, the cost of  
4        borrowing money is less than it would be in times of high interest rates. As  
5        I stated earlier, the Company has asked the Commission, in this proceeding,  
6        to follow its previously approved policy of including in rate base the costs  
7        associated with the construction of the Jasper County generating project.  
8        This policy requires the Company to charge construction interest costs  
9        associated with the Jasper County project to income currently and  
10       eliminates the need to add the interest cost to the overall cost of  
11       construction resulting in a lower final cost of the Jasper County project.  
12       (The Company will discontinue recording AFUDC on those portions of the  
13       investment in Jasper construction that are included in rates in this  
14       proceeding.) Changes in interest rates and the length of the construction  
15       period do not change the relative benefits to be gained for customers by  
16       including CWIP in rate base currently.

17                Furthermore, the inclusion of CWIP in rate base is sound regulatory  
18       policy. It provides for a current cash return on construction expenditures  
19       which provides assurance to investors of the Company's ability to meet its  
20       financial obligations. In today's financial environment investors, creditors  
21       and credit rating agencies are concerned as never before about companies'



1 annual cash flows. The Commission's practice of allowing for current  
2 recovery of construction interest and carrying costs is an essential factor in  
3 SCE&G's ability to maintain its bond interest coverage ratios. The bond  
4 interest coverage ratio is a recognized indicator of a company's ability to  
5 meet its annual interest obligations. As I stated in my direct testimony,  
6 without an acceptable bond interest coverage ratio, the Company's credit  
7 ratings will drop. This would make it difficult to access the financial  
8 markets on reasonable terms to support the Company's construction  
9 program.

10 **Q: THE CONSUMER ADVOCATE'S WITNESS MR. WATKINS HAS**  
11 **TESTIFIED REGARDING THE COMPANY'S NEW JASPER**  
12 **COUNTY GENERATING FACILITY. WHAT COMMENTS DO YOU**  
13 **HAVE IN RESPONSE TO HIS TESTIMONY?**

14 A. Mr. Watkins states that only costs incurred through September 30, 2002  
15 should be included in rate base because he believes such treatment is  
16 consistent with Commission policy. This is not the case. In the initial Cope  
17 proceeding, the Commission set rates to be effective on June 7, 1993 and  
18 put in rates CWIP on the Cope plant incurred up to May 31, 1993. See  
19 Order No. 93-465, dated June 7, 1993. In Order No. 96-15, dated January 9,  
20 1996, the Commission allowed into rate base the cost of the Cope facility  
21 incurred through December 1995.

1     **Q.   PLEASE RESPOND TO THE SUGGESTIONS OF WITNESSES**  
2             **WATKINS AND GOINS THAT THE COPE ACCELERATED**  
3             **DEPRECIATION MECHANISM BE DISCONTINUED.**

4     A.   I disagree with Mr. Watkins and Mr. Goins and respectfully request  
5             that this accounting treatment be extended. The Cope accelerated  
6             depreciation mechanism is a legitimate accounting treatment that may  
7             provide benefits to both SCE&G customers and shareholders.

8             This Commission approved the use of the mechanism in September  
9             of 1999. When invoked, the Company records additional depreciation  
10            related to the Cope Facility, which increases expenses and thereby reduces  
11            earnings to authorized levels. The result is an increase in the Company's  
12            depreciation reserves. Depreciation reserves are deducted from rate base,  
13            reducing the net value of investment in rate base on which earnings are  
14            calculated and rates are determined.

15   **Q:   WHAT BENEFITS DO CUSTOMERS RECEIVE FROM THIS**  
16             **MECHANISM?**

17   A.   SCE&G ratepayers obtain benefits in that downward pressure is placed on  
18             electric rates over the long term. This occurs in two ways: (a) the  
19             depreciated book value of the generation rate base used to serve native  
20             load customers is reduced, and (b) the Company may preserve the ability to  
21             make significant ongoing investments in rate base to meet customer and

1 Company needs (such as environmental improvements) without  
2 necessarily having to increase rates to recover such investments. In this  
3 way, customers obtain the benefit of a reduction in the depreciated book  
4 value of the generation rate base used to serve them, the utility becomes  
5 more cost-competitive because of the reduction in the net book value of its  
6 generating assets, and shareholders and bondholders receive the return of  
7 their investment in those assets. Such a mechanism also sustains a stable  
8 regulatory environment during the time when the Company experiences an  
9 increased level of earnings.

10  
11 **Q. DOES THIS MECHANISM PREVENT THE COMMISSION FROM**  
12 **APPROPRIATELY REGULATING A UTILITY'S RATES AND**  
13 **EARNINGS?**

14 A. No. The Commission retains all its regulatory powers over the Company. If  
15 for whatever reason, the Commission wishes to review the Company's  
16 earnings levels, the Commission may convene a Rule to Show Cause  
17 Hearing or take other appropriate action to reduce rates. By extending this  
18 mechanism, the Commission does not lose any of its regulatory authority  
19 over the Company nor is it prevented from examining the reasonableness of  
20 the Company's electric rate levels going forward, as suggested by Witness  
21 Goins.

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**Q. PLEASE RESPOND TO WITNESS WATKINS' ASSERTIONS  
REGARDING THE NATURE OF THE MECHANISM.**

A. Mr. Watkins states in his testimony that the extension of this accounting treatment is "improper" and that it allows SCE&G to "misrepresent" its financial results. Mr. Watkins statements are inaccurate and misleading.

I want to stress for the Commission that this type of accelerated depreciation is approved by this Commission for another of its jurisdiction electric utilities and, as well, is approved by other utility commissions in the region. SCE&G requested the Commission's approval of the mechanism prior to its use, and the terms and availability of this mechanism are a matter of public record for investors and the public.

As I discussed above, use of the mechanism in no way limits the Commission's ability to regulate a utility's rates or earnings going forward. Nor would use of the mechanism in any way limit or interfere with SCE&G's legal duty to properly disclose and represent its earnings in compliance with reporting requirements of this Commission, the Securities and Exchange Commission and its other regulators. Quarterly financial and earnings reports are provided to the Commission and are of public record. If the accelerated depreciation mechanism were utilized by the Company, it would be included in the Company's quarterly filing to the Commission.

1 Mr. Watkins' attempt to characterize this mechanism as deceptive is simply  
2 wrong.

3 **Q: PLEASE RESPOND TO MR. ELLISON'S PROPOSED ADJUSTMENT**  
4 **TO REMOVE ALL INCENTIVE PAY EXPENSES FROM COST OF**  
5 **SERVICE.**

6 A: Mr. Ellison's adjustment proposes to remove the Company's incentive pay  
7 pro forma adjustment. The sole basis for the proposal is the fact that no  
8 incentive compensation was paid during the test period.

9 **Q: WHAT HAS BEEN THE COMPANY'S HISTORY REGARDING**  
10 **INCENTIVE COMPENSATION PAYOUT?**

11 A. The Company has maintained incentive compensation programs for its  
12 employees since 1986 and the expenses related to them have been included  
13 in rates since Order No. 93-465. These programs encourage company  
14 personnel to focus on improving operations and profitability. Operational  
15 goals include meeting annual business objectives in areas such as  
16 efficiency, quality of service, customer satisfaction, safety, and progress  
17 towards strategic objectives. Completion of these incentive goals results in  
18 direct benefits for customers.

19 Incentive compensation is an integral part of the Company's overall  
20 compensation program. Employees look at compensation as a total package  
21 and see incentive compensation as part of that package. We know from

1 experience that employees place significant weight on incentive  
2 compensation in making their decisions concerning joining the Company or  
3 accepting offers from competitors.

4 Over the past five years Company employees have earned  
5 approximately 62% of targeted incentive pay. Through its pro forma  
6 adjustment in this proceeding, the Company has included 50% of the current  
7 annual incentive program potential payout in cost of service. We believe  
8 this level of expense is reasonable based on past program results and will  
9 encourage employees to achieve successful operational and business  
10 results.

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12 **Q: PLEASE RESPOND TO MR. WILKES ASSERTION THAT THE**  
13 **COMPANY DOES NOT NEED RATE RELIEF.**

14

15 A: Mr. Wilkes asserts that the Company has not done enough to raise the  
16 necessary funds for new generating capacity. He asserts the Company  
17 should issue stock or borrow money to fund our generation expansion and  
18 construction program.

19 It is important to understand that all funds required to meet the  
20 Company's construction needs come either from shareholders or creditors.  
21 Funds provided by shareholders are generated through internal cash flow

1 from operations or from sales of common or preferred stock. In fact since  
2 our last electric rate proceeding in 1995 the Company has issued \$700  
3 million of first mortgage bonds to creditors. SCE&G also sold \$50 million  
4 of preferred stock in 1997. In 1999 SCANA Corporation, SCE&G's parent  
5 company, reduced its common stock dividend by 29% thereby reducing  
6 SCE&G's annual dividend requirement, which provided additional internally  
7 generated cash for construction needs. In addition, SCANA Corporation  
8 just completed the public sale of \$150 million in common stock, all of  
9 which was transferred to SCE&G in the form of common equity.

10 All of these issuances of debt and stock were undertaken to fund  
11 generation expansion expenditures to meet the growing needs of our  
12 customers. These investments in the Company from creditors and  
13 shareholders are not free. Creditors demand a return on their investments in  
14 the form of interest payments, while shareholders expect to earn a  
15 reasonable return on their investments in the form of cash dividends and  
16 stock appreciation. Our ability to pay the returns demanded by our creditors  
17 and shareholders is dependent on obtaining rate relief when necessary to  
18 cover the costs of these investments. We cannot maintain adequate  
19 generating reserves to meet customer demands efficiently and reliably  
20 without adding generation at this time. Without a rate increase to support  
21 these construction expenditures, the Company's bond credit ratings and

1 financial position will deteriorate. If that occurs, it will be difficult to raise  
2 capital on reasonable terms which will raise costs for consumers.

3 **Q: COULD YOU COMMENT ON THE STATEMENT BY MR.**  
4 **GOREMAN THAT SCANA'S FLOTATION COSTS ARE NOT KNOWN**  
5 **AND MEASURABLE ?**

6 A. Yes. Flotation costs are in fact known and measurable. We presently have  
7 very current data on the costs of flotation to SCANA in today's market. The  
8 cost of SCANA's most recent issuance of \$150.6 million in common stock  
9 which closed on October 16, 2002, was in excess of \$6.43 million or 4.24  
10 % of the issuance.

11 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

12 A. Yes.